



Transcript Exhibit(s)

Docket #(s): W-01445A-00-0962

Exhibit #: A3, S8, AVIA-1, RUCCO 2

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AZ CORP COMMISSION
DOCUMENT CONTROL

ARIZONA WATER COMPANY

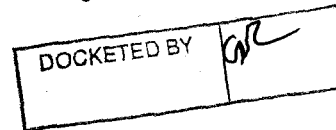


Docket No. W-1445A-⁰⁰01-0962



Arizona Corporation Commission
DOCKETED

JUL 08 2003



2000 RATE HEARING EXHIBIT NO. ____

For Test Year Ending 12/31/99

PREPARED
DIRECT TESTIMONY
OF
Ralph J. Kennedy

Phase II of Proceeding

ARIZONA WATER COMPANY

Direct Testimony of

Ralph J. Kennedy

Q. WHAT IS YOUR NAME, EMPLOYER AND OCCUPATION?

A. My name is Ralph J. Kennedy. I am employed by Arizona Water Company (the "Company") as Vice President and Treasurer.

Q. DID YOU PREVIOUSLY SUBMIT YOUR QUALIFICATIONS AND TESTIFY ON BEHALF OF THE COMPANY IN THE FIRST PHASE OF THIS CASE?

A. Yes, I did.

Q. WHAT IS THE PURPOSE OF YOUR TESTIMONY IN THIS PHASE TWO PROCEEDING?

A. At the Open Meeting of the Arizona Corporation Commission (Commission) on April 22, 2003, the Recommended Opinion and Order in Phase II of this proceeding was discussed. The Commission directed the Hearing Division to conduct additional proceedings regarding the inclusion of potential leasing options of arsenic treatment facilities in the recommended Arsenic Cost Recovery Mechanism (ACRM) for the Company. The Administrative Law Judge (ALJ) issued a Procedural Order on April 25 directing the parties to engage in settlement discussions with the goal of filing a joint recommendation for resolving the leasing issues by May 30. If agreement was not reached, the Procedural Order provided that testimony would be filed and a hearing held on June 26. The parties met on two occasions and engaged in productive settlement discussions. The Company and Staff modified their original positions and came close to

1 reaching an overall agreement but missed the established deadline for doing so.
2 The Company and Staff moved closer together regarding the recovery of O&M
3 costs in the ACRM and the manner in which leasing costs could be recovered
4 through the ACRM.

5 The purpose of my testimony in this portion of the proceeding is to present
6 the Company's position regarding the recovery of lease costs and operating and
7 maintenance expenses ("O&M costs"), the need for a balanced ACRM that treats
8 leasing and owning (constructing) arsenic treatment facilities equally, and provide
9 information on the availability of grants and loans for arsenic treatment facilities. I
10 will also set forth the Company's position on Staff's revised ACRM proposal that
11 has evolved as a result of the settlement discussions.

12
13 **Q. ARE YOU SPONSORING ANY EXHIBITS IN THIS PROCEEDING?**

14 **A.** Yes, I am sponsoring two exhibits: Exhibit RJK-1 titled "Estimated Revenue
15 Requirements of Leased Arsenic Treatment Facilities" and Exhibit RJK-2 which is
16 a four page funding options document given to me by its originator at the Water
17 Infrastructure Financing Authority (WIFA).

18
19 **Q. WAS EXHIBIT RJK-1 PREPARED BY YOU OR UNDER YOUR DIRECTION**
20 **AND SUPERVISION?**

21 **A.** Yes, it was.

22 **Q. PLEASE SUMMARIZE THE COMPANY'S ORIGINAL POSITION REGARDING**
23 **THE RECOVERY OF O&M COSTS AS PART OF THE ACRM.**

24 **A.** This phase of the rate case for the Company's Northern Group systems deals
25 with two interrelated issues: (1) approval of a procedure for the Company to
26 recover costs incurred to comply with the new Maximum Contaminant Level
27

1 ("MCL") for arsenic, imposed by the U.S. Environmental Protection Agency
2 ("EPA") under the Safe Drinking Water Act, and (2) consolidation of rates and
3 charges for water service by the Company's Northern Group systems, as
4 authorized in Decision No. 64282 (Dec. 28, 2001). One of the primary areas of
5 disagreement in this phase of the case has been the inclusion of O&M costs in
6 the ACRM.
7

8 There is no dispute that approximately half of the cost of service
9 associated with complying with the new arsenic maximum contaminant level
10 ("MCL") will be O&M costs and that those costs will be significant. Under the
11 ACRM as originally proposed by the Company, the Company would be allowed
12 to recover its actual, recorded arsenic O&M costs. These costs would consist of
13 either the costs for operating and maintaining arsenic treatment facilities that the
14 Company constructs or, alternatively, the payments required under an operating
15 lease with a third-party contractor, who will design, build and own the facilities
16 and service the media. In either case, the Company will have to maintain
17 appropriate records that accurately segregate these costs from the Company's
18 general operating expenses. The Company will also have the burden of
19 submitting schedules and supporting documentation evidencing the amount of
20 these expenses.
21

22 As I testified in the prior proceedings on the ACRM, the Company has
23 been engaged in discussions with outside contractors who would design, build
24 and own the arsenic treatment facilities and service the media under a lease
25 arrangement with the Company. Under this type of arrangement, the revenue
26 requirement would be lower because the Company would not own the facilities or
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1 incur any traditional capital costs: depreciation, property taxes, rate of return, and
2 income taxes on its return. In addition the equipment supplied under a short-term
3 lease may be designed to have a shorter economic life and therefore use less
4 expensive components than Company constructed facilities. These possible
5 design differences would further reduce the capital cost of leased facilities. This
6 type of lease arrangement may well be the most cost-effective approach for
7 complying with the new arsenic MCL by the required January 2006 deadline.
8

9 A short-term operating lease reduces the financing burden on the utility
10 by eliminating the need to obtain financing from a lender and places the risk of
11 treatment plant obsolescence on the contractor/lessor. This arrangement will
12 require the Company to make monthly payments to the lessor. If O&M costs are
13 excluded from the ACRM, none of these payments – which can easily be tracked
14 and verified – could be recovered outside a general rate case. For this reason,
15 we argued that the ACRM should, at a minimum, include the costs of leasing
16 arsenic treatment facilities.
17

18 **Q. PLEASE OUTLINE THE PHASE II ARSENIC COST RECOVERY MECHANISM**
19 **THAT THE ADMINISTRATIVE LAW JUDGE RECOMMENDED IN THE**
20 **OPINION AND ORDER AS FILED IN THIS DOCKET ON APRIL 8, 2003.**

21 **A.** The Recommended Opinion and Order ("ROO") would authorize an ACRM for
22 the Company's Northern Group systems. The ACRM process recommended by
23 the ALJ includes only capital-related costs which were identified in the ROO as:
24 return on the original (actual) cost of constructing the facilities, additional federal
25 and state income taxes relating to the revenue increase, property taxes, and the
26 depreciation expense associated with the new plant. The ROO would limit the
27
28

1 number of step increases under the ACRM to two. As a condition for approval of
2 the ACRM, the ROO would require the Company to file a general rate application
3 for its Northern Group systems no later than September 30, 2007, based on a
4 2006 test year.

5 The ROO adopts Staff's recommendation regarding rate design, which
6 splits ACRM costs between the monthly minimum charge and commodity
7 charges, with increasing responsibility based on meter size.

8 To mitigate significant costs that the Rimrock system is expected to
9 incur as a result of the new arsenic MCL, the ROO adopts the Company's rate
10 consolidation proposal, which for ratemaking purposes consolidates the Sedona
11 and Rimrock systems in a two-step process.

12 The first step would establish a common minimum charge for both the
13 Rimrock and Sedona Systems. This would occur as part of the first ACRM filing.
14 The second consolidation step will occur in the Northern Group's general rate
15 case based on test year 2006; it would establish a common commodity charge
16 for the consolidated Rimrock and Sedona systems.

17
18
19 **Q. PLEASE DISCUSS THE DESIRABILITY OF LEASING OPTIONS AND THE**
20 **NEED FOR A BALANCED ACRM THAT TREATS LEASING AND OWNING**
21 **(CONSTRUCTING) ARSENIC TREATMENT FACILITIES EQUALLY.**

22 **A.** From the inception of these proceedings, it has been the Company's position that
23 arsenic O&M costs should be included in the ACRM to reduce rate shock when
24 the permanent rates based on the 2006 test year become effective and to allow
25 recovery of significant arsenic treatment costs that are not included in the
26 existing rates. Recovery of O&M costs through the ACRM is also needed to
27
28

1 assist the Company in financing the mandatory arsenic treatment facilities to
2 meet the January 2006 compliance date. Authorizing the inclusion of leasing
3 options in the ACRM is another positive step that can reduce the magnitude of
4 the Company's arsenic treatment facility financing needs while benefiting the
5 customers by meeting the new January 2006 arsenic MCL without over-
6 committing to the present state of arsenic treatment technology.
7

8 The Company and Staff now propose to modify the ACRM set forth in
9 the ROO to allow recovery of lease costs and specific, limited O&M costs.

10 **Q. PLEASE SUMMARIZE THE PROPOSED MODIFICATIONS TO THE ROO.**

11 **A.** The proposed modifications to the ROO agreed to by the Company and Staff
12 establish a balanced recovery mechanism that does not favor owning arsenic
13 treatment facilities over leasing of arsenic treatment facilities. Although there are
14 other, simpler ways to accomplish this goal, the Company accepts the Staff's
15 proposal whereby recovery of the capital portion of an operating lease is limited
16 to the lower of the capital costs in the lease or the level of recovery that would be
17 allowed if the Company owned the arsenic treatment facilities.
18

19 The Company and Staff were also able to reach agreement on the
20 recovery of O&M costs that meets both parties' concerns. The Company was
21 concerned over the impact of significant, unrecovered O&M costs on its financial
22 condition and ability to finance the required arsenic treatment facilities. Staff and
23 RUCO were concerned over their ability to evaluate the reasonableness of the
24 unrecovered O&M costs and be certain that none of the unrecovered O&M costs
25 was included in current rates. The Company and Staff agreed that their differing
26 concerns could be satisfied by limiting recoverable O&M costs in the ACRM to
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28

1 specific media related costs: (1) media replacement or regeneration costs; (2)
2 media replacement or regeneration service costs; and (3) waste media or
3 regeneration disposal costs (collectively referred to as the "recoverable O&M
4 costs"). These recoverable O&M costs will be billed to the Company by a third
5 party and will not have been previously included in current rates. This greatly
6 simplifies the task of verifying the appropriateness of recoverable O&M costs
7 while also providing more timely recovery of an important segment of the total
8 O&M costs. Whether the arsenic treatment facility is owned or leased recovery of
9 O&M costs through the ACRM would be limited to these specific recoverable
10 O&M costs. Determining the amount of recoverable O&M costs for constructed
11 facilities is straight-forward. The recoverable costs will be based on invoices from
12 the contractor providing the recoverable O&M costs. Determining the portion of
13 the lease payment that represents recoverable O&M costs is not as direct.

14
15 **Q. HOW WILL THE PORTION OF THE LEASE PAYMENT THAT REPRESENTS**
16 **RECOVERABLE O&M COSTS BE DETERMINED?**
17

18 **A.** To assist the parties in the ACRM proceedings in evaluating lease costs and
19 isolating recoverable O&M costs, the Company will require lessors to provide
20 specific information that identifies the three following components of the lease
21 payment for arsenic treatment facilities: 1) equipment construction costs, 2)
22 recoverable O&M costs and, 3) other O&M costs. The lessor will also be required
23 to provide the interest rate embedded in the lease payment. Not all lessors may
24 be willing to provide this information. In this case they would be disqualified even
25 if they submitted the lowest cost bid.
26
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1 Q. ONCE THE THREE COMPONENTS OF THE LEASE COST HAVE BEEN
2 ESTABLISHED HOW WILL THE RECOVERABLE O&M COSTS BE
3 TREATED?

4 Recoverable O&M costs will be treated the same whether the arsenic treatment
5 facility is constructed or leased. Two categories of recoverable O&M expenses
6 are eligible for recovery through the ACRM: 1) Costs that have been incurred
7 and deferred in the twelve months prior to the ACRM filing and, 2) Costs that will
8 continue to be incurred after the ACRM filing. Deferred costs will be recovered
9 through a surcharge while recurring costs will be recovered through an
10 adjustment in base rates.
11

12 The deferral of recoverable O&M costs will begin upon operation of the
13 arsenic treatment facility. Recoverable O&M costs shall be deferred until such
14 time as an ACRM filing is made in which recovery is sought for the deferred
15 recoverable O&M costs. This addresses Staff's concerns that O&M costs must
16 not be estimates and must be known and measurable. In addition, the Company
17 agrees to limit the deferral period to a twelve month period that begins at the later
18 of either the in-service date of the arsenic treatment facility or the twelve-month
19 period prior to the month in which the ACRM request is filed. The deferral period
20 would be determined on an individual arsenic treatment facility basis. The
21 Company can choose when to request each individual arsenic treatment facility's
22 deferred recoverable O&M cost recovery through an ACRM step filing, however if
23 an ACRM recovery is not requested within twelve months of the in-service date
24 some of the deferred recoverable O&M costs would have to be written off and
25
26
27
28

1 never recovered. As in the ROO there can only be two ACRM filings per water
2 system before the next general rate proceeding for the Northern Group systems.

3 The second category, recurring, recoverable O&M costs would also be
4 considered at the same time that recovery of the deferred O&M is requested
5 through an ACRM filing. However, after recurring, recoverable O&M costs were
6 determined they would be recovered through an increase in base rates. The
7 Company could choose when to request recovery of each individual arsenic
8 treatment facility's recoverable O&M cost recovery through an ACRM step filing,
9 but once the prospective level of recoverable O&M costs have been established
10 for a specific treatment facility, they would remain at that level until new rates are
11 established in the next general rate proceeding.
12

13 **Q. HOW WOULD CAPITAL COSTS BE RECOVERED?**

14 A. Capital costs, whether for a leased or constructed facility, would be recovered
15 through an increase in base rates in the same manner as recurring recoverable
16 O&M costs.
17

18 **Q. DID THE COMPANY AND STAFF AGREE ON HOW THE REVENUE**
19 **REQUIREMENTS ESTABLISHED AS THE RESULT OF AN ACRM FILING**
20 **WOULD BE RECOVERED?**

21 A. Yes. The Company and Staff agreed that the ACRM revenue requirements could
22 include deferred recoverable O&M costs, and both prospective recoverable O&M
23 costs and capital costs.
24

25 No more than twelve months of deferred recoverable O&M costs would
26 be included in the ACRM revenue requirements and would be recovered through
27 a surcharge that would be in effect for twelve-months following approval of the
28

1 ACRM. The surcharge amount shall be determined using the same billing
2 determinants used to establish the revised rates in the ACRM filing. The
3 surcharge revenue requirement would be split between the common monthly
4 minimum and the other half to the Rimrock and Sedona system's existing
5 commodity charge so that the existing commodity charge difference between
6 them would not be widened. Staff and Company agree that there will be no true
7 up of the ACRM.
8

9 The prospective recoverable O&M costs and capital costs would be
10 recovered through an adjustment in base rates. Half of the revenue requirement
11 would be recovered by an increase in the minimum charge and the other half
12 would be recovered by increasing the commodity charge with increasing
13 responsibility based on meter size following the rate design recommendation
14 adopted in the ROO.
15

16 **Q. IS THE COMPANY SEEKING A RETURN ON THE DEFERRED**
17 **RECOVERABLE O&M COSTS?**

18 A. No. Although there is a financing cost associated with the deferred recoverable
19 O&M costs, the Company is not requesting a return on the deferred recoverable
20 O&M costs..

21 **Q. HAVE YOU PREPARED AN EXHIBIT THAT PROVIDES AN ILLUSTRATION**
22 **OF THE CALCULATION OF THE REVENUE REQUIREMENT OF LEASED**
23 **ARSENIC TREATMENT FACILITIES?**

24 A. Yes. Exhibit RJK-1 sets forth the Company's understanding and expectation of
25 how the recovery of the capital costs and the recoverable O&M costs for leased
26 facilities will be computed.
27
28

1 Availability of Grants and Loans for Arsenic Treatment Facilities

2 Q. THE APRIL 8, 2003 PROCEDURAL ORDER DIRECTED THE COMPANY TO
3 ADDRESS THE AVAILABILITY OF GRANTS AND LOANS FOR ARSENIC
4 TREATMENT FACILITIES. WHAT INFORMATION HAS THE COMPANY
5 DEVELOPED?

6 A. The Company investigated the availability of grants and loans for financing
7 installation of arsenic treatment facilities through Internet searches and a meeting
8 and discussion with WIFA.

9
10 On its own, prior to the Commission's directive, the Company had
11 applied for eligibility to participate in the EPA's Treatment Technology Research
12 Demonstration program. EPA is going to build up to 12 full-scale demonstration
13 plants nationwide in the first phase of this program. Two of the first phase
14 demonstration plants will be built in the Company's Northern Group, one in the
15 Rimrock water system and the other in the Valley Vista water system that is
16 within the Sedona system. At the conclusion of the demonstration project the
17 Company may acquire the facility at a significant cost savings.
18

19 The Company also met with representatives of WIFA, the agency that
20 administers the Drinking Water State Revolving Fund for Arizona, to obtain
21 information on the availability of grants and loans for arsenic treatment facilities.
22 WIFA provided information to the Company on the potential sources of grants
23 and loans and eligibility criteria. Exhibit RJK-2 is a four-page document on
24 arsenic funding options that WIFA presented on May 2, 2003 to the Arizona
25 Water Pollution Control Association. Although WIFA identified eight sources for
26 grants or loans for arsenic treatment facilities, seven have restrictions that
27
28

1 disqualify the Company. The disqualifying restrictions include population,
2 geographic and income levels. Based upon our discussions with WIFA and
3 review of the eligibility criteria, it appears that the Company would not qualify for
4 seven of the programs.

5 The Company as well as other investor owned water utilities is eligible
6 to apply for a WIFA loan from the eighth source identified by WIFA. WIFA loans
7 differ from the Company's existing financing and payment methods because they
8 are granted to single system utilities for a specific project and generally have
9 shorter maturities than the Company's exiting long-term debt. WIFA evaluates the
10 borrower on a system basis and requires that rates that will support the loan
11 must be approved prior to the award. WIFA loan proceeds are provided on a
12 draw down basis that requires payment of the vendor's invoices by WIFA instead
13 of the Company. Historically, the Company has combined all of its annual
14 construction projects into a series of one-year loans that would be repaid with the
15 proceeds of a periodic long-term bond issue. The Company's accounting is
16 based on direct payments to its vendors. Although it appears that the Company
17 could be eligible for WIFA loans, more investigation is needed to determine if
18 WIFA's standard administrative requirements would be workable for the
19 Company and if loans to the Company would be the best use of WIFA's limited
20 arsenic treatment facilities financing pool.

21
22
23 **Q. DOES THIS CONCLUDE YOUR DIRECT TESTIMONY IN THIS MATTER, MR.**
24 **KENNEDY?**

25
26 **A.** Yes, it does.

EXHIBITS

EXAMPLE

Estimated Revenue Requirements of Leased Arsenic Treatment Facilities

Exhibit RJK-1

Assumptions:

	Lease Option	Purchase Option
Cost of Constructed/Purchase Arsenic Treatment Facility	\$ 200,000	\$ 200,000
Lessor's Embedded Interest Rate	10%	
Annual O&M Costs	\$ 14,000	\$ 14,000
Components Of Annual Lease Payment		
Capital Cost	\$ 36,000	\$ 40,000
O&M-Portion		
Media replacement or regeneration (50%)	7,000	7,000
Media replacement service costs (15%)	2,100	2,100
Waste disposal costs (10%)	1,400	1,400
Subtotal-Recoverable O&M	10,500	10,500
Other O&M (25%)	3,500	3,500
Total O&M	\$ 14,000	\$ 14,000
Annual Revenue Requirement	\$ 46,500	\$ 50,500

Annual Capital Recovery limited to lesser of The Capital Cost Under The Purchase Option (\$40,000) or The Capital Cost Under The Lease Option (\$36,000)

Example of Recoverable O&M Expenses and Capital Cost Recovery

Recoverable O&M Expenses Incurred (Media replacement/regeneration, media replacement/regeneration service, and waste disposal costs):

First Month of Operation	875.00
Second Month of Operation	875.00
Third Month of Operation	875.00
Fourth Month of Operation	875.00
Fifth Month of Operation	875.00
Sixth Month of Operation	875.00
Seventh Month of Operation	875.00
Eighth Month of Operation	875.00
Ninth Month of Operation	875.00
Tenth Month of Operation	875.00
Eleventh Month of Operation	875.00
Twelfth Month of Operation	875.00
	10,500.00

	Recoverable		
	Surcharge	Base Rates	
If ACRM filed after :	Deferred O&M	Recurring O&M	Capital Cost
- In-Service Date	0.00	0.00	36,000.00
- First Month of Operation	875.00	875.00	36,000.00
- Second Month of Operation	1,750.00	1,750.00	36,000.00
- Third Month of Operation	2,625.00	2,625.00	36,000.00
- Fourth Month of Operation	3,500.00	3,500.00	36,000.00
- Fifth Month of Operation	4,375.00	4,375.00	36,000.00
- Sixth Month of Operation	5,250.00	5,250.00	36,000.00
- Seventh Month of Operation	6,125.00	6,125.00	36,000.00
- Eighth Month of Operation	7,000.00	7,000.00	36,000.00
- Ninth Month of Operation	7,875.00	7,875.00	36,000.00
- Tenth Month of Operation	8,750.00	8,750.00	36,000.00
- Eleventh Month of Operation	9,625.00	9,625.00	36,000.00
- Twelfth Month of Operation	10,500.00	10,500.00	36,000.00

EXHIBIT RJK-2



WIFA

Funding Options For Arsenic Projects 2003 AWPCA Conference/May 2, 2003

Moncef Tihami
Environmental Manager

Water Infrastructure Finance Authority

Points of Discussion

- Funding Agencies
- Discussion Format
- Agency Specific Program Overview
- Arsenic Special Allocation
- Recommended Strategy
- Questions

+



WIFA

Funding Agencies

- Community Development Block Grant (CDBG)
- Border Environmental Cooperation Commission (BEEC)
- Environmental Protection Agency (EPA)
- North American Development Bank (NADBank)
- US Department of Commerce, Economic Development Administration (EDA)
- USDA Rural Development (RD)
- Water Infrastructure Finance Authority (WIFA)



WIFA

Discussion Format

Name of Funding Entity

- Type of Program
- Type of Projects & Financial Assistance
- Population Restrictions
- Geographic Restrictions
- Income Restrictions
- Interest Rates (if Applicable)
- Terms (if Applicable)
- Contact: Name and Phone Number



WIFA

EXHIBIT RJK-2

Community Development Block Grant

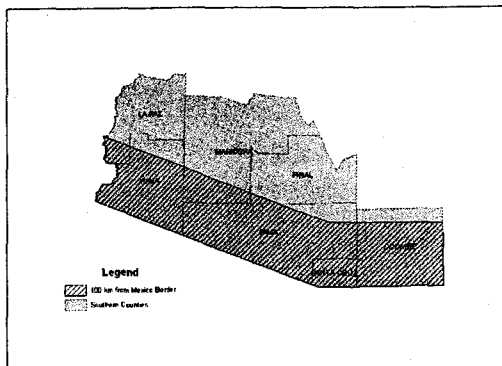
- State Program
- Planning, Design & Construction Grants
- Population Restrictions – None
- Geographic Restrictions – None
- Income Restrictions – Beneficiaries = Low Income
- Interest Rates = Not Applicable
- Terms = Not Applicable
- Contact: Joy Johnson (602) 771-1041

WIFA

BECC/EPA

- Federal Program
- Planning, Design & Construction Grants & Loans
- Population Restrictions – None
- Geographic Restrictions – 100 Km from Mexican Boarder
- Income Restrictions – None
- Interest Rates = Gov = Municipality & NGO = Prime+
- Terms = Max 20 Years & requires Certification
- Contact: Carlos Quintero 1-877-277-1703 Ext: 4608
EPA Evelyn Wachtel (415) 972-3410

WIFA

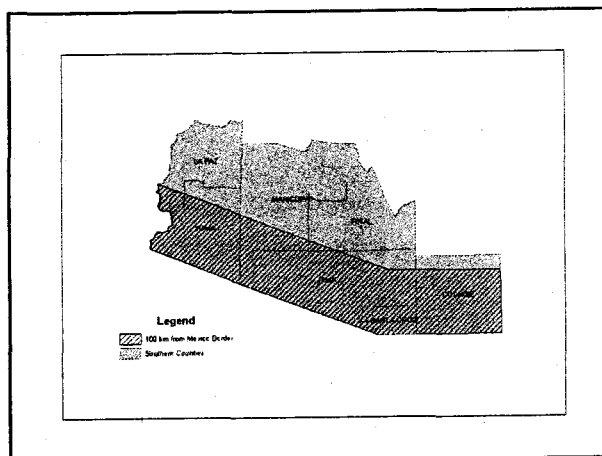


NADBank/EPA

- Federal Program
- Planning, Design & Construction Grants & Loans
- Population Restrictions – None
- Geographic Restrictions – 100 Km from Mexican Boarder
- Income Restrictions – None
- Interest Rates = Gov = Municipality & NGO = Prime+
- Terms = Max 20 Years & requires Certification
- Contact: Jeff Snowden (210) 231-8000
EPA Evelyn Wachtel (415) 972-3410

WIFA

EXHIBIT RJK-2



US Department of Commerce Economic Development Administration

- Federal Program
- Construction Grants
- Population Restrictions – None
- Geographic Restrictions – None
- Income Restrictions – Job Creation or Retention
- Interest Rates = Not Applicable
- Terms = Not Applicable
- Contact: Jake Macias (206) 220-7666

WIFA

USDA Rural Development

- Federal Program
- Construction Grants & Loans
- Population Restrictions – Area Serves Under 10,000
- Geographic Restrictions – “Colonias” Grants = Border Counties
- Income – Lower Income = More Subsidy
- Interest Rates = 3.5% to 5.5% & NGO = Prime+
- Terms = Max 40 years for Gov & Max 10 Years for NGO
- Contact: Leonard Gradias (602) 280-8747
Frank Bernal (602) 280-8749

WIFA

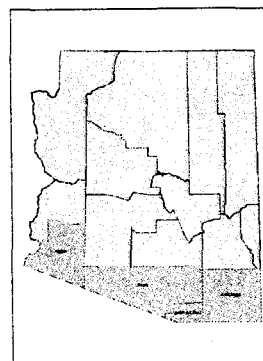


EXHIBIT RJK-2

WIFA

- State Program
- Planning, Design & Construction Grants & Loans
- Population Restrictions – None
- Geographic Restrictions – None
- Income Restrictions – lower income Higher Subsidy
- Interest Rates = Government AAA Municipalities and NGO = Prime+
- Terms = Max 30 Years
- Contact: Suzanne Price (602) 364-1314

WIFA

EPA Estimate for Arsenic Compliance

- \$877 Million Nationwide
- Under Estimates True Costs

WIFA

Recommended Strategy

- Start Planning Early
- Review Arsenic Master Plan
- Seek Debt Authority – ACC, Election or Petition
- Apply to Every Funding Agency Possible
- Waiting for New Technologies

WIFA

Questions

Moncef Tihami, Environmental Manager

WIFA

1110 West Washington, Suite 290

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LEGAL



BEFORE THE ARIZONA CORPORATION COMMISSION

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IN THE MATTER OF THE APPLICATION OF
ARIZONA WATER COMPANY, AN ARIZONA
CORPORATION, FOR ADJUSTMENTS TO ITS
RATES AND CHARGES FOR UTILITY
SERVICE FURNISHED BY ITS NORTHERN
GROUP AND FOR CERTAIN RELATED
APPROVALS.

DOCKET NO. W-01445A-00-0962

**STAFF'S NOTICE OF FILING
SUPPLEMENTAL TESTIMONY**

Staff of the Arizona Corporation Commission hereby files the supplemental testimony of
Gordon Fox of the Utilities Division in the above-referenced matter.

RESPECTFULLY SUBMITTED this 18th day of June 2003.

David Ronald

David Ronald, Attorney
Legal Division
Arizona Corporation Commission
1200 West Washington Street
Phoenix, Arizona 85007
(602) 542-3402

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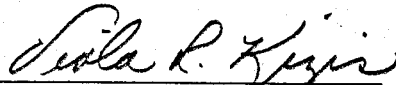
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28

SUPPLEMENTAL

TESTIMONY

OF

GORDON L. FOX

ARIZONA WATER COMPANY

DOCKET NO. W-01445A-00-0962

JUNE 18, 2003

BEFORE THE ARIZONA CORPORATION COMMISSION

MARC SPITZER

Chairman

JIM IRVIN

Commissioner

WILLIAM A. MUNDELL

Commissioner

JEFF HATCH-MILLER

Commissioner

MIKE GLEASON

Commissioner

IN THE MATTER OF THE APPLICATION OF)
ARIZONA WATER COMPANY, AN ARIZONA)
CORPORATION, FOR ADJUSTMENTS TO ITS)
RATES AND CHARGES FOR UTILITY)
SERVICE FURNISHED BY ITS NORTHERN)
GROUP AND FOR CERTAIN RELATED)
APPROVALS)
_____)

DOCKET NO. W-01445A-00-0962

SUPPLEMENTAL

TESTIMONY

OF

GORDON L. FOX

REVENUE REQUIREMENTS MANAGER

UTILITIES DIVISION

ARIZONA CORPORATION COMMISSION

JUNE 18, 2003

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**EXECUTIVE SUMMARY
ARIZONA WATER COMPANY
DOCKET NO. W-01445A-00-0962**

Arizona Water Company ("AWC" or "Company") provides potable water service to approximately 60,000 customers in eight counties and 18 water systems in Arizona.

The current proceeding is phase two of the Company's permanent rate case for the five water systems (Lakeside, Overgaard, Rimrock, Pinewood, and Sedona) that comprise the Northern Group. Decision No. 64282, dated December 28, 2001, established permanent rates in phase one of this docket. In phase two, the Company is requesting to establish a procedure to recover costs related to complying with the Environmental Protection Agency's new 10 parts per billion ("ppb") maximum contaminant level ("MCL") for arsenic. Through an arsenic cost recovery mechanism ("ACRM"), the Company proposes to recover capital cost related to the removal of arsenic with a surcharge to minimum monthly charges and operation and maintenance ("O&M") expenses with a surcharge to the commodity rate. Arizona Water requests that up to three ACRM surcharge filings be allowed for each water system through the end of 2006 when it must comply with the 10 ppb MCL for arsenic. The Company is also requesting rate consolidation in Sedona and Rimrock.

Staff, RUCO, and the Company ("Parties") filed testimonies, and hearings were held on these issues. The Administrative Law Judge issued a recommended opinion and order ("ROO"), dated April 8, 2003, pertaining to these issues. At the April 22, 2003, Open Meeting the Commission directed the Hearing Division to conduct additional proceedings regarding the inclusion of potential leasing options for arsenic treatment facilities. Lease costs were not addressed in the initial testimonies/hearings.

The Parties met on May 20, 2003, and discussed leasing options. The Company proposed modifications to the ROO to allow recovery of lease costs and certain O&M expenses. Staff did not recommend recovery of any O&M costs in its initial testimony. However, Staff has reviewed the Company's proposal and agrees that under certain procedures/conditions that recovery of three *specific* O&M costs via the ACRM is appropriate. Staff is recommending procedures/conditions for allowing recovery of lease costs and certain O&M expenses.

1 **INTRODUCTION**

2 **Q. Please state your name, occupation, and business address.**

3 A. My name is Gordon L. Fox. I am a Revenue Requirements Manager employed by the
4 Arizona Corporation Commission ("ACC" or "Commission") in the Utilities Division
5 ("Staff"). My business address is 1200 West Washington Street, Phoenix, Arizona 85007.
6

7 **Q. Did you previously file testimony in this docket?**

8 A. Yes. I filed responsive testimony in this docket on September 23, 2002.
9

10 **BACKGROUND**

11 **Q. Please provide a background that explains the purpose of your testimony.**

12 A. In Decision No. 64282, dated December 28, 2001, the Commission approved a rate
13 increase for Arizona Water Company's ("AWC" or "Company") Northern Division
14 ("Phase I"). That decision ordered this docket to remain open to allow Staff, RUCO, the
15 City of Casa Grande, and AWC ("Parties") to develop a proposed procedure for the
16 recovery of costs relating to arsenic treatment and to address the issue of rate
17 consolidation of the Company's systems. Testimonies were filed and hearings were held
18 on these issues. On April 22, 2003, the Commission discussed the Administrative Law
19 Judge's ("ALJ") Recommended Opinion and Order ("ROO"), dated April 8, 2003,
20 pertaining to those issues. At that April 22, 2003, Open Meeting, the Commission
21 directed the Hearing Division to conduct additional proceedings regarding the inclusion of
22 potential leasing options for arsenic treatment facilities and directed the Company to
23 investigate all possible loans and grants that may be available for financing installation of
24 arsenic treatment facilities.
25

1 On April 25, 2003, the ALJ issued a Procedural Order directing (1) the parties to engage
2 in and complete settlement discussions on the leasing issues no later than May 30, 2003;
3 (2) the parties to file, by May 30, 2003, a joint recommendation for resolving the leasing
4 issues or if no agreement is reached, for testimony to be filed by June 16, 2003, and a
5 hearing to be held on June 26, 2003; and (3) the Company to separately address the
6 availability of grants and loans for arsenic treatment facilities.
7

8 On May 20, 2003, the Parties met and discussed leasing options. AWC proposed
9 modifications to the arsenic cost recovery mechanism ("ACRM"), as proposed in the
10 ROO, to allow recovery of lease costs and certain operating and maintenance expenses.
11 AWC identified nine operating and maintenance ("O&M") expenses (as outlined in the
12 ADEQ Arsenic Master Plan) related directly to arsenic treatment and proposed allowing
13 recovery in the ACRM of three of those expenses: (1) media replacement or regeneration;
14 (2) media replacement or regeneration service; and (3) waste disposal. AWC proposed to
15 allow recovery of these O&M expenses regardless of whether they are included in lease
16 payments in order to place leasing and purchasing options on an equal footing. Staff
17 requested time to consider AWC's proposal, and the Parties agreed to request an extension
18 of time to consider responses to AWC's proposal.
19

20 Staff concluded that AWC's proposal, with refinements, would comply with the goals
21 sought for the ACRM. Those objectives included: (1) legality; (2) administrative
22 efficiency; (3) timely recovery of costs outside a separate rate case; and (4) fair and
23 reasonable results. This testimony presents Staff's current position regarding the ACRM.

1 **ACRM MODIFICATIONS**

2 **Q. Does Staff recommend any changes to the ACRM as presented in the ROO?**

3 A. Yes. Staff supports two significant modifications to the ROO ACRM. These
4 modifications are consistent with those proposed by AWC in the May 20, 2003, meeting.
5 First, Staff supports allowing recovery of direct costs (no overheads) for media
6 replacement or regeneration, media replacement or regeneration service, and waste
7 disposal (recoverable O&M), but no other O&M. Second, Staff supports allowing
8 recovery of capital and O&M costs under lease obligations. The amount that should be
9 recoverable under lease obligations is the same as that which would have been recoverable
10 had the leased assets been purchased. These modifications are subject to the
11 procedures/conditions described below.

12
13 **Operating and Maintenance Expenses**

14 **Q. What procedures/conditions does Staff recommend regarding recoverable O&M?**

15 A. The ACRM should provide for recovery of recoverable O&M costs in two parts. The first
16 part allows deferral and recovery of recoverable O&M via a surcharge. The deferral
17 period is defined below. The second part provides for recovery of recoverable O&M in
18 ACRM revised rates on a prospective basis. These two parts provide for deferred
19 recovery of a limited amount of recoverable O&M and for prospective recovery via
20 ACRM revised rates based on the historical cost in the deferral period.

21
22 The ROO ACRM provides for two ACRM revised rate filings. For each arsenic removal
23 plant, the amount of recoverable O&M to be deferred and the amount to be recognized
24 prospectively in revised rates should both be determined at the same time, that is, in either
25 the first or second ACRM filing. AWC should have the option of choosing either the first
26 or second ACRM filing. If there is no second ACRM filing and AWC does not choose the

1 first ACRM filing, the deferred and prospective O&M amounts should be determined in
2 the next general rate case. If the first ACRM filing is chosen, then, the dollar amount of
3 O&M included in the first ACRM revised rates should remain in effect for the second
4 ACRM revised rates, and the minimum and commodity surcharges and period as
5 established in the first ACRM filing are unaffected. The amount of recoverable O&M to
6 be included for annual recovery in ACRM revised rates should be equal to the amount
7 deferred. Thus, the amount included prospectively in revised rates will be the same as the
8 recoverable O&M from the deferral period, a period of 12 or fewer months.
9

10 The deferral period for each arsenic removal plant should begin with its in-service date
11 and should not exceed 12 months. In the event that AWC's ACRM filing to request
12 recovery of recoverable O&M occurs more than 12 months after the in-service date, the
13 deferral period should be adjusted to reflect the 12 consecutive months preceding that
14 ACRM filing. If the in-service date is less than 12 months prior to AWC's ACRM filing
15 to request recovery of recoverable O&M, the deferral period should be the period
16 beginning with the in-service date and ending with the month-end prior to the month of
17 AWC's request. If AWC makes a second ACRM filing and did not request recovery of
18 recoverable O&M in its first ACRM filing, it should request recovery of O&M in its
19 second ACRM filing. In the event that AWC makes no second ACRM filing, the deferral
20 period should be the test year in AWC's next general rate case. No deferrals should be
21 recognized preceding or subsequent to the deferral period defined here. No cost of money
22 should be applied to deferred amounts. The deferred amounts should be recovered via a
23 surcharge.
24

25 The surcharge should be determined using the same billing determinants used to establish
26 revised rates in the ACRM filing. Fifty percent of the surcharge should be recovered from
27 the monthly minimum charge and 50 percent through the commodity rate to conform with

1 the rate structure used for recovery of other ACRM amounts. The surcharge should be
2 applied to 12 consecutive monthly billings beginning in the month that the ACRM revised
3 rates become effective or the month that permanent rates become effective in the next
4 general rate case as is applicable. There should be no true-up.
5

6 **Leases**

7 **Q. What procedures/conditions does Staff recommend regarding leases?**

8 A. The ACRM revenue requirement should recognize the same, or essentially the same,
9 revenue requirement whether arsenic treatment equipment is leased or purchased. To
10 accomplish equal treatment for leases and purchases, leased equipment should be included
11 in the ACRM procedures in the same manner as if it had been purchased. Accordingly,
12 AWC should require lessors to provide the equipment purchase price and the cost of
13 money rate embedded in its lease payment. Furthermore, for all lease costs that AWC
14 submits for recovery via the ACRM, AWC should require lessors to provide separate lease
15 payment components for arsenic treatment equipment, recoverable O&M, and costs not
16 recoverable via the ACRM. Further, AWC should conduct a lease versus purchase
17 analysis to support its decision to lease or purchase. AWC should maintain this
18 supporting analysis and make it available for Staff's review in its next general rate case.
19

20 **Property Taxes**

21 **Q. Does Staff recommend that the ACRM include a provision for recovery of property**
22 **taxes?**

23 A. No.
24

25 **Q. Does this conclude your direct testimony?**

26 A. Yes, it does.



Arizona Utility
Investors Association

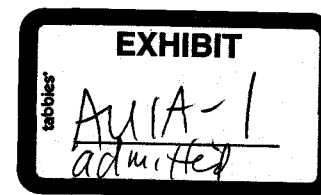
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Commissioner
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Commissioner

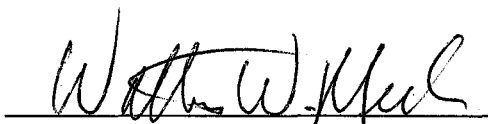


IN THE MATTER OF THE APPLICATION OF
ARIZONA WATER COMPANY, AN
ARIZONA CORPORATION, FOR ADJUST-
MENTS TO ITS RATES AND CHARGES FOR
UTILITY SERVICE FURNISHED BY ITS
NORTHERN GROUP AND FOR CERTAIN
RELATED APPROVALS.

DOCKET NO.
W-01445A-00-0962

NOTICE OF FILING

Pursuant to the Procedural Order issued April 25, 2003, the
ARIZONA UTILITY INVESTORS ASSOCIATION, INC. (AUIA) hereby
submits the direct testimony of Walter W. Meek. Respectfully
submitted this 18th day of June, 2003.


Walter W. Meek, President

CERTIFICATE OF SERVICE

An original and 13 copies of the referenced
testimony were filed this 18th day of June,
2003, with:

Docket Control
Arizona Corporation Commission
1200 W. Washington
Phoenix, AZ 85007

Copies of the referenced testimony were delivered this 18th day of June, 2003, to:

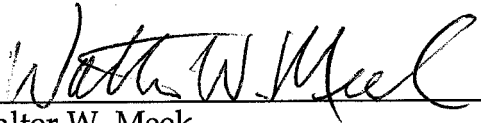
Marc Spitzer, Chairman
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Copies of the referenced testimony were mailed this 18th day of June, 2003, to:

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Casa Grande, AZ 85222



Walter W. Meek

1 DIRECT TESTIMONY

2 OF

3 WALTER W. MEEK
4
5
6
7

8 Q. PLEASE STATE YOUR NAME AND BUSINESS ADDRESS.

9 A. My name is Walter W. Meek. My business address is 2100 North Central
10 Avenue, Suite 210, Phoenix, Arizona 85004.
11

12 Q. BY WHOM ARE YOU EMPLOYED AND IN WHAT CAPACITY?

13 A. I am the president of the Arizona Utility Investors Association ("AUIA"
14 or "Association"), a non-profit organization formed to represent the
15 interests of equity owners and bondholders who are invested in utility
16 companies that are based in or do business in the state of Arizona.
17

18 Q. DOES THE AUIA MEMBERSHIP INCLUDE THE OWNERS AND
19 OPERATORS OF ARIZONA WATER COMPANIES?

20 A. Yes. AUIA's members include large Class A water companies and
21 smaller Class B and C water companies. In addition, AUIA is an
22 associate member of the Water Utilities association of Arizona and three
23 of the members of the AUIA board of directors are from the water
24 industry.
25

26 Q. HAS AUIA BEEN GRANTED INTERVENTION IN THIS
27 PROCEEDING?

28 A. Yes. AUIA was a late-filed intervenor.
29

30 Q. HAVE YOU FILED TESTIMONY PREVIOUSLY IN THIS MATTER?

31 A. No. We did not participate in the Arizona Water Company's northern
32 division rate case. We chose to intervene only in the portion related to
33 arsenic cost recovery after the Commission's April 22 open meeting.
34

1 Q WHAT IS AUIA'S INTEREST IN THESE ISSUES?

2 A. AUIA has been involved intermittently in the arsenic issue since the 10-
3 parts-per-billion (ppb) limitation was proposed by the Environmental
4 Protection Agency in the Clinton Administration. We joined with other
5 parties in Arizona, New Mexico and California in urging that the rule be
6 re-examined when the national administration changed hands.

7

8 Q. HAS AUIA CONTINUED TO BE INVOLVED IN THIS ISSUE?

9 A. Yes. After the Bush Administration affirmed the 10 ppb limit, AUIA
10 joined an ad hoc task force of Arizona stakeholders who attempted to lay
11 the groundwork for expedited recovery of arsenic treatment costs. The
12 task force included the Arizona Department of Environmental Quality
13 (ADEQ), the Water Infrastructure Financing Agency (WIFA), RUCO and
14 Commission Staff, among others.

15

16 Q. WHAT WAS AUIA'S CHIEF CONCERN?

17 A. From the birth of the 10 ppb proposal, we have been apprehensive that
18 compliance with the standard would impose a significant and perhaps
19 unmanageable financial burden on private Arizona water companies.
20 We have also been concerned that the Commission would find it
21 difficult to produce a cost recovery mechanism that would compensate
22 water companies fully and on a timely basis.

23

24 Q. WHAT ISSUES DOES YOUR TESTIMONY ADDRESS?

25 A. I will discuss only two issues: the recovery of O & M costs within the
26 Arsenic Cost Recovery Mechanism (ACRM) and the treatment of leasing
27 costs. However, I would like to offer a clarification at the outset.

28

29 Q. WHAT IS THE CLARIFICATION?

30 A. AUIA asserted in its application for intervention that it would not
31 reopen issues that have already been litigated in this case. The
32 recommended opinion and order, which is pending, asserts that O&M

1 will not be recoverable under the ACRM and it is RUCO's position that
2 O&M is a closed issue. However, based on representations made at
3 recent settlement meetings, Staff is clearly willing to reconsider that
4 issue on a limited basis and AUIA is responding.

5
6 Q. HAVE THE POSITIONS OF THE PARTIES CHANGED REGARDING
7 O&M?

8 A. To some degree, yes. To put it in context, I should point out that the
9 company, in settlement discussions, divided arsenic mitigation into two
10 scenarios for its Sedona system. One was a construction scenario, in
11 which AWC would build, own and operate the required arsenic
12 treatment facilities. In the second scenario, a lessor would build and
13 operate the facilities for a fixed lease payment over four years.

14
15 Q. HOW WAS O&M TREATED IN THE FIRST SCENARIO?

16 A. In the context of the construction scenario, the company proposed that
17 three specific costs devoted entirely to arsenic treatment be recoverable
18 as a part of the ACRM. Those costs were identified as 1) media
19 replacement costs, 2) replacement service costs, and 3) waste media
20 disposal costs.

21
22 Q. HOW DID THE OTHER PARTIES REACT TO THIS PROPOSAL?

23 A. In its counter proposal of June 9, Staff accepted the notion of including
24 these specific cost elements in the ACRM, classifying them as "Approved
25 O&M Recovery." I believe RUCO continues to oppose the inclusion of
26 any O&M in the ACRM.

27
28 Q. DOES AUIA HAVE A POSITION ON THIS PROPOSAL?

29 A. Yes. AUIA supports the inclusion of these costs in the ACRM for the
30 following reasons:

- 31 • These expenses are clearly identifiable and easily tracked without audit
- 32 complications.

- They represent a pure pass-through, with no overhead charges.
 - Early recovery of these specific costs create no threat that AWC will over-earn as a result.
 - Recovery will mitigate the ongoing impact of O&M costs, which in many arsenic treatment regimens may be as burdensome to the water company as the capital outlays for facilities.
- In short, this proposal would go a long way toward meeting the Commission's objective of reducing the financial burden of arsenic treatment without undermining rate-of-return regulation.

Q. PLEASE EXPLAIN THE LEASING SCENARIO.

A. It should be noted that AWC acquired actual bids from vendors for a specific treatment option under both the construction and leasing scenarios. The fixed-price leasing offer included all costs over the four-year lease period except property taxes. In other words, all O&M was included in the proposed lease payment.

Q. IS THERE A SIGNIFICANT DIFFERENCE IN COST TO THE RATEPAYER BETWEEN THESE PROPOSALS?

A. Yes. According to the information provided by AWC, the annual revenue needed to support the lease scenario is 34 percent less than the revenue requirement for the construction scenario.

Q. HOW DID THE PARTIES REACT TO THE LEASE SCENARIO?

A. I believe RUCO continues to oppose recovery of O&M, even if it is buried in an all-inclusive lease. The Staff position, as I understand it, is that the lease should be broken down so that O&M costs can be separated into components that are recoverable and those that are not. In that way, Staff proposes to put construction and leasing on equal footing.

Q. IS THAT POSSIBLE?

1 A. The concept escapes me. It may be possible to put the O&M components
2 on a comparable basis, but the economics of a leased facility will usually
3 be based on very different parameters from the traditional construction
4 and amortization cycle of a regulated utility.

5
6 Q. ARE THERE PROBLEMS WITH THE STAFF'S APPROACH TO
7 LEASING?

8 A. There may be. In this case, AWC has said they are not sure that the
9 lessor would consent to dissecting the lease to expose the O&M and
10 capital components. The company contends that the lease should be
11 treated as an all-inclusive transaction in which the entire cost of the
12 lease would be recoverable through the ACRM.

13
14 Q. WHAT IS AUIA'S POSITION?

15 A. Our overall position is that the Commission should not impose any
16 unnecessary conditions that would preclude leasing arsenic treatment
17 facilities, not only for AWC, but also for any other water companies. It is
18 unclear to AUIA what will be accomplished by dissecting the lease. If the
19 system meets EPA and ADEQ specifications and if the lease is less costly
20 to ratepayers, then the cost components should be irrelevant.

21
22 Q. HOW WOULD A LEASE AFFECT THE COMPANY'S EARNINGS?

23 A. It wouldn't have any effect. Like the Staff's "Approved O&M Recovery,"
24 the lease cost is a pure pass-through, with no company overhead
25 included and no rate-of-return or earnings implications.

26
27 Q. BESIDES COST, WHAT ARE SOME ADVANTAGES TO LEASING?

28 A. AUIA has identified at least two.
29 First, at this point in time, the company and its customers may benefit
30 substantially from not becoming locked into a specific treatment
31 technology, which could become obsolete in a few years.

1 Second, small water companies may not be able to raise capital for
2 treatment facilities, especially if they are unable to recover O&M costs on
3 a timely basis. If leasing is not restricted, it could be the best or only
4 solution for financially strapped water companies.

5
6 Q. UNDER AWC'S LEASING SCENARIO, WHAT WOULD HAPPEN AT
7 THE END OF THE LEASE PERIOD?

8 A. The company could have various options, which could include
9 renewing the existing lease for a longer or shorter period or building or
10 leasing new facilities utilizing different technology.

11
12 Q. ARE YOU CONCERNED THAT AWC COULD BE LEFT "HOLDING THE
13 BAG" WHEN THE LEASE EXPIRES?

14 A. I don't see how that could happen. Their options four years down the
15 road would be no worse than they are today and they would have the
16 benefit of operating experience they don't have now. In the meantime,
17 AWC would have met its obligations to meet the arsenic standard and
18 would have saved some money for its customers.

19
20 Q. DO YOU HAVE ANY CONCLUDING REMARKS?

21 A. Yes. The major unresolved issue between the company and
22 Commission Staff is the treatment of lease costs – whether the cost of a
23 lease can be recovered fully under the ACRM. AUIA believes that the
24 Staff's and RUCO's preoccupation with O&M costs may threaten the
25 leasing scenario as a viable solution to arsenic compliance, not only for
26 AWC but for many other water providers under the Commission's
27 jurisdiction. Unless the Staff can support its anxiety with verifiable risk
28 factors, the Commission should accept leasing as a recoverable expense.
29 Otherwise, the Commission will deny ratepayers the least-cost option.

30
31 Q. IS THAT THE END OF YOUR TESTIMONY?

32 A. Yes, it is.

RUCO 2
admitted

BEFORE THE ARIZONA CORPORATION COMMISSION

2003 JUN 18 A 9:25

AZ CORP COMMISSION
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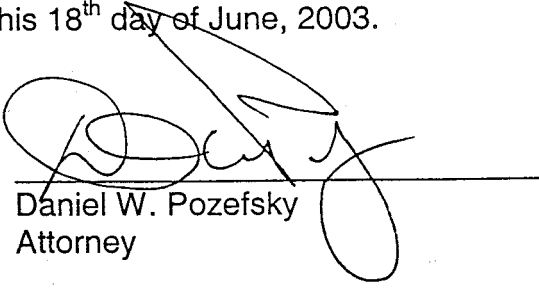
MARC SPITZER
CHAIRMAN
JIM IRVIN
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WILLIAM A. MUNDELL
COMMISSIONER
JEFF HATCH-MILLER
COMMISSIONER
MIKE GLEASON
COMMISSIONER

IN THE MATTER OF THE APPLICATION OF
ARIZONA WATER COMPANY, AN ARIZONA
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ITS RATES AND CHARGES FOR UTILITY
SERVICE FURNISHED BY ITS NORTHERN
GROUP AND FOR CERTAIN RELATED
APPROVALS.

Docket No. W-01445A-00-0962

NOTICE OF FILING

The Residential Utility Consumer Office ("RUCO") hereby provides notice of filing the
Phase II Supplemental Direct Testimony of Marylee Diaz Cortez, in the above-referenced
matter.

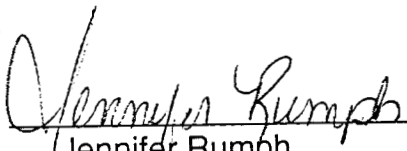
RESPECTFULLY SUBMITTED this 18th day of June, 2003.
Daniel W. Pozefsky
Attorney

1 AN ORIGINAL AND THIRTEEN COPIES
2 of the foregoing filed this 18th day
3 of June, 2003 with:

4 Docket Control
5 Arizona Corporation Commission
6 1200 West Washington
7 Phoenix, Arizona 85007

8 COPIES of the foregoing hand delivered/
9 mailed this 18th day of June, 2003 to:

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ARIZONA WATER COMPANY
DOCKET NO. W-01445A-00-0962

PHASE II

SUPPLEMENTAL DIRECT TESTIMONY
OF
MARYLEE DIAZ CORTEZ

ON BEHALF OF
THE
RESIDENTIAL UTILITY CONSUMER OFFICE

JUNE 18, 2003

1	Introduction	1
2	The Recommended Opinion and Order	3
3	Arsenic Lease Discussions	5
4	RUCO's Recommendation	6

5

6

Introduction

Q. Please state your name for the record.

A. My name is Marylee Diaz Cortez.

Q. Have you previously filed testimony in this docket?

A. Yes. In Phase I of this docket I filed testimony on June 26, 2001, surrebuttal testimony on August 21, 2001, provided oral testimony on the Phase I hearing beginning on September 5, 2001. In the Phase II portion of this docket I filed direct testimony on September 23, 2002, and provided oral testimony at the hearing beginning on October 3, 2002.

Q. What issues were resolved in the Phase I portion of this docket?

A. Rate base, operating income, cost of capital, and the overall revenue requirement issues were resolved by Decision No. 64282.

Q. What was the purpose of the Phase II portion of this docket?

A. The purpose of the Phase II portion of this docket was to address the following two issues:

- 1) Formulation of a mechanism for the recovery of arsenic treatment costs; and
- 2) Consideration of rate consolidation among certain systems for purposes of arsenic cost recovery.

1 Q. What position did RUCO take on these issues?

2 A. RUCO's position on these issues was set forth in its direct testimony filed on
3 September 23, 2002 and at the hearing on October 3, 2002. In summary, RUCO
4 made the following recommendations:

- 5 1) Establish an Arsenic Cost Recovery Mechanism (ACRM) that
6 would allow the Company to file for recovery of its investment in
7 arsenic treatment plant, without having to file an additional rate
8 case;
- 9 2) The ACRM filing would be an abbreviated procedure limited to
10 recovery of completed, used and useful arsenic plant.
- 11 3) The ability to confine the filing to an abbreviated procedure would
12 only be possible by limiting the scope of the filing to arsenic plant
13 investment. Additional issues such as consideration of operating
14 and maintenance (O&M) costs would create the need for full rate
15 review in order to avoid piecemeal ratemaking.
- 16 4) The ACRM should be set for each water system on a stand-alone
17 cost of service basis. This will prevent the cross-subsidization
18 among systems that is inherent in rate consolidation.
- 19 5) Arizona Water would be limited to two rate filings under the ACRM
20 procedure and a full rate case filing would be required in 2006.
21
22

The Recommended Opinion and Order

Q. After a full hearing on these issues did the Administrative Law Judge issue a Recommended Opinion and Order?

A. Yes. The Administrative Law Judge issued a twenty page Recommended Opinion and Order resolving all the issues set forth in the Phase II portion of this docket.

Q. Please summarize the Recommended Opinion and Order's resolution of the issues?

A. The Recommended Opinion and Order found the following:

- 1) It is appropriate for Arizona Water to recover through the ACRM capital costs associated with arsenic treatment compliance. However, O&M costs may not properly be recovered through the ACRM.
- 2) Arizona Water may seek two-step increases through the ACRM process during the interim period prior to its general rate application in 2007.
- 3) Arizona Water shall file a full rate application by no later than September 30, 2007, based on a 2006 test year.
- 4) Arizona Water's proposal to consolidate the Sedona and Rimrock systems for ratemaking purposes is a reasonable approach to mitigate the significant rate impact that is expected to be experienced by customers in those systems.
- 5) The "earnings test" that is to be employed during Staff's audit of the ACRM step increases is properly based on a system basis, rather than a

1 group basis, consistent with the establishment of general rates on a
2 system by system basis.

3
4 Q. Did the Phase II Recommended Opinion and Order go to Open Meeting for
5 Commission consideration?

6 A. Yes. This matter underwent Commission consideration at the April 22, 2003
7 Open Meeting. Arizona Water filed exceptions to the provision of the
8 Recommended Opinion and Order that excluded O&M costs from the ACRM.
9 The Company further argued that the Recommended Opinion and Order made
10 no provision for how leased arsenic plant would be treated under the ACRM.
11 Arizona Water argued for the first time that the absence of a leasing provision in
12 the ACRM would bias the Company's decision toward owning, even if leasing
13 might be more cost-effective.

14
15 Q. In its Phase II application did the Company propose an ACRM methodology for
16 lease arsenic costs?

17 A. No. Arizona Water did not mention the issue of arsenic treatment lease costs
18 prior to filing its exceptions to the Recommended Opinion and Order.
19 Consequently, there is nothing in the record in this docket to support a ruling on
20 arsenic lease costs.

1 Q. At April 22, 2003 Open Meeting did the Commissioners' on vote the Phase II
2 Recommended Opinion and Order?

3 A. No. The Commissioners discussed the Recommended Opinion and Order at
4 length and ultimately decided that the parties should supplement the evidence in
5 the record to include the issue of lease costs. A procedural order was issued
6 that called for discussions among the parties regarding a mutually acceptable
7 way of handling the lease costs in the ACRM and called for the parties to file
8 testimony on their individual positions, if an agreement was not reached.
9

10 **Arsenic Lease Discussions**

11 Q. Pursuant to the Commissioners' request did the parties meet to discuss the
12 arsenic lease costs?

13 A. Yes. Several meetings took place. As instructed by the Commission, the issue
14 of lease costs in the ACRM was discussed.
15

16 Q. Were other aspects of the ACRM beyond the lease issue discussed?

17 A. Yes. Arizona Water and the Staff revisited many of the issues that were already
18 addressed at the Phase II hearing and ruled upon in the Recommended Opinion
19 and Order. Specifically, there was much discussion of O&M costs, and property
20 taxes and how they should be treated in the ACRM. Both the Staff and the
21 Company set forth various proposals on how they felt the Recommended Order
22 should have resolved these other issues.
23

1 Q. Did RUCO take a position on these other issues?

2 A. Yes. During discussions RUCO took the position that the Recommended
3 Opinion and Order had already resolved all the litigated issues and the only
4 remaining task was to resolve the arsenic lease cost issue, pursuant to the
5 Commission's request. RUCO indicated that nothing had changed since the
6 issuance of the Recommended Opinion and Order and that it would not support a
7 revisit to O&M costs and other already-litigated and resolved issues.
8

9 **RUCO's Recommendation**

10 Q. What is your recommendation to the Commission on how arsenic lease costs
11 should be incorporated in the ACRM?

12 A. RUCO believes that the ACRM should be broadened to consider ratemaking
13 treatment of decisions either to build or lease arsenic plant. The treatment of
14 lease costs should parallel the ACRM treatment set forth in the Recommended
15 Opinion and Order for arsenic plant investment. In other words, the manner in
16 which the ACRM is designed should not in and of itself influence a decision to
17 lease vs. own.
18

19 Q. How would this be accomplished?

20 A. The ACRM would allow the portion of the lease payment associated with the
21 capital cost¹ of the leased arsenic plant to be afforded ratemaking treatment in
22 the same manner that the capital cost of owned arsenic plant is treated under the

¹ The lessor would be required to provide a detailed break down of the capital & O&M costs associated with the monthly lease payment.

1 Recommended Opinion and Order. Specifically, the ACRM would afford
2 recovery of the return on, and depreciation of, the incremental arsenic plant.
3 O&M costs would not be recovered via the ACRM and would require examination
4 in a full rate case. This would require an amendment to the Recommended
5 Opinion and Order to include ACRM recovery of the capital portion of any arsenic
6 operating leases entered into.

7
8 Q. Is any other amendment necessary?

9 A. No. The only issue that is not currently resolved by the Recommended Opinion
10 and Order is the lease issue. Thus, the only amendment required is the lease
11 amendment.

12
13 Q. Do you have reason to believe that other parties to this docket may intend to
14 propose additional amendments, beyond the lease issue?

15 A. Yes. The Staff and Arizona Water have discussed various additional
16 amendments to the Recommended Opinion and Order, most notably,
17 amendment to the ACRM's treatment of operating and maintenance expenses.
18 RUCO, the Staff, and the Company have already prefiled testimony on these
19 issues and under went cross-examination on their positions on these aspects of
20 the ACRM. Those positions are a matter of record and are incorporated in the
21 Recommended Opinion and Order. Regardless of whether other parties depart
22 from their prefiled positions, RUCO's positions as set forth in its Phase II direct
23 testimony remain unchanged.

1 Q. Does this conclude your direct testimony?

2 A. Yes.

3

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